Transaction Cost and Theory of the Firm

Why Might......

- McDonald’s form a close relationship with their meat suppliers as opposed to buying from the cheapest “supplier of the week”?
- Michigan cherry growers create a cooperative to freeze cherries?
- Frito-Lay contract directly with potato growers?

Determinants of Structure

- Exogenous view
  - Scale economies
  - Regulatory frameworks
  - Firms optimize given the structure
- Endogenous view
  - Private optimization
  - Social optimization
  - Structure reflects overall cost min
  - Transaction cost approach
Why do Firms Exist?

U Coase/Williamson:
UY The boundary of firms is determined by transaction costs
dü Cost of using the market vs. cost of integration
dü Economies of Specialization vs. Diseconomies of integration

Reacting to the Cost of Exchange

Transaction Characteristics

Transaction Cost

Type of Coordination

Sources of Transaction Costs

U Economic uncertainty
U Bounded rationality
U Opportunism
**Economic Uncertainty**

- Characteristics of trading partners
- Prices of goods and services
- Product quality
- Product availability

**Bounded Rationality**

- Economic players are limited in their ability to process information and make decisions
- Incomplete contracts
- Information asymmetries

**Opportunism**

- "Self-interest seeking with guile"
- Imperfect commitment
- Taking advantage of other parties in the transaction
Transaction Characteristics

U Frequency
U Degree of Complexity/Uncertainty
U Degree of Asset specificity

Types of Asset Specificity

U Site
U Physical Capital
U Human Capital
U Dedicated Assets

Bringing the Transaction into the Firm....

U Costs
Y More “activities” in AgriFood system = More complex planning
Y Giving up “economies of scale” advantage in production cost
U Gains
Y Access to information--technology, demand data, product characteristics
Y Control over input supply--quantity, quality, timing
Continuum of Vertical Coordination

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Barkema: New Roles and Alliances in the U.S. Food System

Reacting to the Cost of Exchange

Transaction Characteristics

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Type of Coordination

Integration

✓ Relieves Hold Up/Moral Hazard Issues
✓ Holdup...asset value is contingent upon upstream/downstream market access
✓ F&V vs. grains
✓ Moral Hazard...value of asset is contingent upon upstream/downstream behavior that is hard to observe/monitor
✓ Employee vs. Owner
✓ First handlers contribution to quality
✓ What is the cost of integration?
TC Economics in Agriculture

- Explanation of likely governance structures
  - Cooperative vs. Investor owned firm
  - Anti-Trust issues
    - Market power vs. efficiency
    - Tyson cattle case
  - Culture and Legal infrastructure impact on institutions

TC Economics in Agriculture

- Explanation of *rigidity* based on asset specificity
  - Unwillingness to adapt
  - Cost reduction vs. flexibility tradeoff

TC Economics in Agriculture

- Designing Food System Institutions
- Market reform
  - What institutions best offer credible commitment?
  - Sustainable markets
TC Economics in Agriculture

✓ How do technological changes impact TC?
✓ “Apple” transport computer
✓ E-coli “sniffer”
✓ Veterinary advances in swine/poultry
✓ How do governance structures respond?

Limits of the Theory

✓ Still weak in predictive ability
✓ Partly because many TC’s are commodity-specific
✓ Lower TC as only criterion for private governance choice
✓ Ignores 3rd party effects
✓ Private optimum vs. social optimum